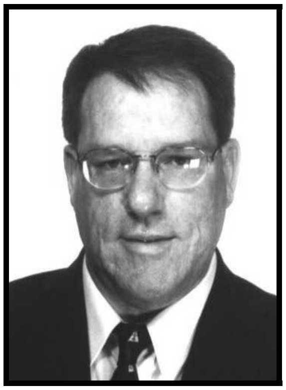
Two Cents Worth



Douglas F. Hudson, CMA, MBA, CFP, CD

In This Issue

November, 1998

CRASH SURVIVABILITY

As I write this, I am just finishing Garth Turner's newest book "**The Defence - Guarding Your Money in Uncertain Times**" (see book review page 7). If you really want to know what's going on with the world and the markets, and what you should be doing to protect your hard earned assets - buy the book and read it.

Now for my two cents worth which can be summed up as this:

Quality - Balance - Diversification

If you had a portfolio made up of the following asset classes:

- Foreign Equities
- Canadian Equities
- Canadian Bonds
- Cash and near cash (money market)

and if your foreign equities were spread out over the US, Europe, and the rest of the world - you probably either broke even, or are up or down a couple of percent from where you were twelve months ago (see sample portfolios on following page).

If you ignored balance and diversification in order to chase performance, to time the market, or jumped from one industry sector to another, well you either lucked-in or you didn't.

How are investors reacting to the recent turn of events? In the CNN Financial Network on-line poll, 67% of the respondents were more worried about the state of the economy than they were six months ago. In the same poll, 30.88% said that they had made big changes to their portfolios in the previous four weeks. The next one is inter-

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Fidelity - Sample Portfolio		One Year	Three Year
Canadian Growth	50%	-0.12%	14.60%
Canadian Bond	30%	7.50%	10.10%
Growth America	5%	6.70%	16.70%
European Growth	5%	17.60%	20.80%
International	**10%**	**3.90%**	**15.60%**
Weighted Return	100%	**3.79%**	**13.77%**

Here is the same portfolio with the Fidelity Emerging Market Fund substituted for the International Fund:

Fidelity - Sample Portfolio		One Year	Three Year
Canadian Growth	50%	-0.12%	14.60%
Canadian Bond	30%	7.50%	10.10%
Growth America	5%	6.70%	16.70%
European Growth	5%	17.60%	20.80%
Emerging Markets	**10%**	**-48.80%**	**-23.61%**
Weighted Return	100%	**-1.48%**	**9.84%**

Balance and Diversification in operation. Even with a fund that lost 48.80% over the last twelve months in the second portfolio, it isn't the end of the world.

It is not enough to throw off a retirement plan based upon a 10% growth rate.

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esting: 29.03% moved money from stocks to CD/Money market and 28.73% moved money from CD/Money market to stocks.

The last question was informative "Finally, if the Dow were to fall another 10 percent this year what would you do? Answer: 58.23% would buy stocks and 38.84% would continue holding. Four percent would sell their stocks and the remainder would stuff their money under the mattress.

The vast majority, 92%, have decided that they are holding the course or going shopping.

To go to CNN's special report on "**Investing in Troubled Times**" go to this link: http://www.cnnfn.com/specials/investing/

If you go to this site and read some of the articles you will see an expression over and over - "flight to quality". What is quality? I have a simple definition for this - anything that Warren Buffet would own. For an example of what Warren Buffet would own, look up the holdings of the Infinity International fund or the Fidelity Focus Consumer Industries fund at either The Fundlibrary or the Globefund sites. For Canadian content, look up the Infinity Canadian fund or their Income and Growth fund.

Now, back to reality: In a recent article in the Toronto Star, Elaine Carey, Toronto Star Demographics Reporter pointed out that in 1951, Canadians 65 and over made up 8 per cent of the population, or slightly more than one million people. By 1996, there were 3.5 million seniors, more than 12 per cent of the population. And by 2020, as baby boomers hit old age, more than one in five Canadians will be seniors.

So if you are a boomer, or other wise mistrustful of the government's ability to support you in your golden years, then **you still have to save for your retirement**. That hasn't changed.

The worst thing that you could do is allow the media gloom and doomers to convince you to do something that is not in your best interest. That would be to pull your money out of your investments and to let it rot in the money market.

If you are determined to look after your financial future, then keep these three principles in mind - quality, balance and diversification and you will attain your objectives no matter what happens with the markets.

@rgentum Mutual Funds The "Quant" Family of Funds

Have you ever played chess against a computer and won? I came close once, but I have never beaten the computer. So why not a mutual fund company that selects their fund holdings using a sophisticated model and using all of the relevant market intelligence available?

This combination certainly seems to be working for new kid on the block - "@rgentum Management & Research Corporation". Their funds have been kicking-butt relative to their benchmark indexes since their introduction in June of this year.

@rgentum is a new family of funds that employs time-proven techniques of fundamental money management with the most advanced technological and quantitative resources available.

@rgentum is the brainchild of Fred Pye. Fred is a well-known figure in the Canadian mutual fund industry. A few years ago Fred could be seen at brokerages and financial planning firms pushing a new Canadian Fund company - Fidelity Investments. We all know what a success story Fidelity is today.

I met Fred in July of this year and as it turned out we recognized each other, but we couldn't figure out from where. We determined that it had to be from sailing on Lac St-Louis. Fred is an avid sailor and he speaks about sailing with the same passion that he brings to the workplace. I caught up again with Fred recently and he took some time out from his hectic cross-country schedule to answer a few questions:

Doug: Fred, can you tell me a little bit about your background?

Fred: Well Doug, I've been in the investment industry since the early eighties and have probably done every job on the street. I started in the trenches as a floor trader, I've pounded the pavement in New York and, I am most known in Canada for the contribution I made to building Fidelity Investments Canada.

Doug: What motivated you to start your own fund company?

Frederick T. Pye, President and CEO, @rgentum Management & Research Corp.

Fred: Opportunity mostly. There is no company in Canada that offers a family of quantitative products and all the attractive benefits that come with these products. This product-line is created for sophisticated financial advisors and their clients who are looking for consistent, conservative and top-performing management.

Doug: Why doesn't everyone else do this?

Fred: At some point in time, most likely the near future, fund companies one by one will start launching quantitative products. This

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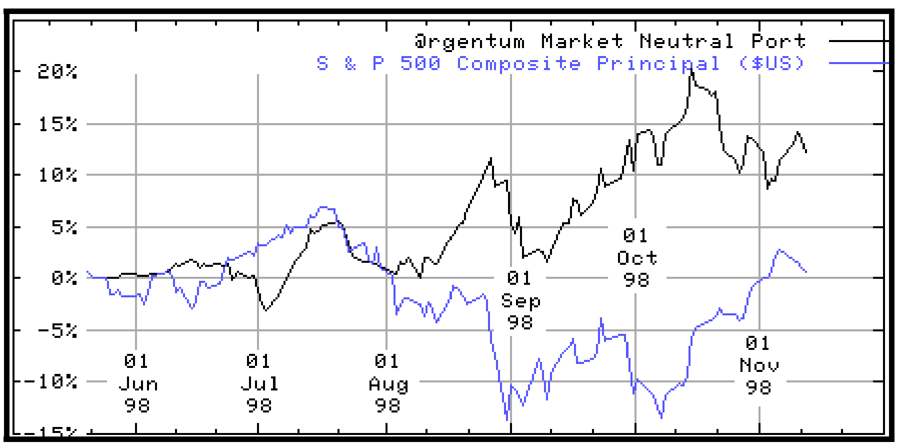
can't happen overnight because the development time can take years. I firmly believe that it will be at least three years before anyone will come close to what we offer.

Doug: I completed my MBA (finance) in 1982. Back then I was convinced that all money managers used quantitative methods to select their portfolios. When I joined the industry I was very surprised to find out that this was not the case. I recently read somewhere that one out of every two mutual funds introduced in the United States is a "quant" fund. Why is it that more managers are not using quantitative methods and computer modeling to select their portfolios here in Canada?

Fred: The biggest difference between Canada and the U.S. has been the availability of data and an efficient database. If you are going to run portfolios by computer, your computer must know everything about all companies, all the time. Only recently has Canada had this database luxury through an innovative and great firm called CPMS. We have to be very careful to know and understand the difference between using computers to analyze data to assist in fundamental analysis, which every one does, and running a portfolio on a purely quantitative basis.

Doug: Everyone is excited about your "market neutral" fund. There is no question that this is the fund that has been in the limelight these last few months because it has performed exactly as expected. (see graph). So now for the hardest question of all - how does this fund work? What makes it less risky that the S&P 500 and why would one expect to have better than average returns than the Index over the long run?

Fred: This fund employs a Conservative Jones model. What we do is look for 15 to 20 of the best equity investments and buy them. We then look for 15 to 20 of the worst equity investments and sell them short. By combining both "long" and "short" positions in one portfolio, we are able to lower the risk and volatility of that portfolio. A traditional mutual fund owns a diversified portfolio of companies and will generally move up with the market. Unfortunately it will also move down with the market. By employing our strategy we hope to lower the volatility by profiting regardless of market direction.



The Market Neutral Portfolio handily out-performed the S&P 500 during the most recent financial crisis.

This is a non-RRSP eligible fund with a $150,000 minimum investment.

Doug: I understand that you will do a fair bit

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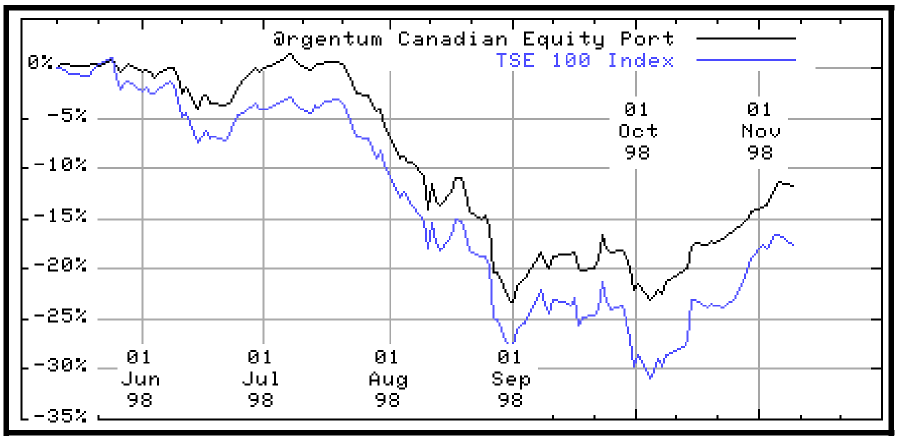
of trading. If a company no longer meets your criteria it is out and a new one is in. Do your models include a factor for the cost to effectuate a trade?

Fred: Actually our portfolios have done a lot less trading than more traditional portfolios, but yes we did include all costs in our models.

Doug: I understand that you have some new funds coming out? What's new on the horizon?

Fred: As you know, @rgentum blends the best of the traditional methods of money management with the newest technology available. Look closely for all kinds of combinations of new products. What is most impressive is how our initial product line is performing. A graphic view of our Canadian Equity portfolio versus the TSE300 is impressive indeed! Thanks Doug.



The @rgentum Canadian Equity fund can be seen here out-performing the TSE. The same is true of their small cap fund vs. the Nesbitt Burns small cap index. Both funds are RRSP eligible with a $5,000 minimum investment.

Canadian Equity Portfolio

Managed by Hillsdale Investment Management, the Canadian Equity Portfolio is designed to provide core exposure to Canadian large capitalization companies. The manager uses sophisticated quantitative techniques to select the most attractive 20 to 30 stocks from the 125 largest companies on the Toronto Stock Exchange.

Sample Measures of Valuation

Price Earnings Ratio
This is a measure of how the expectation of profits of the companies in the portfolio are reflected in their price.

TSE 300 = 17.06
@ = 13.94

Percent Book Value Growth
This is a measure of what rate the book value of the portfolio's companies are expected to grow at.

TSE 300 = 6.48
@ = 8.29

Percent Quarterly Earnings Growth
This is a measure of what rate the profits of the portfolios companies are growing at on a quarterly basis.

TSE 300 = -1.74
@ = 3.74

@rgentum has probably one of the better fund company websites. Details on their valuation methods and fund breakdowns by company can be found there:

http://www.rgentum.com/en/index.html

RESP or In Trust Account Which is Better?

Probably one of the biggest abuses perpetrated on well-intentioned Canadians has been the RESP and most recently the Canadian Education Savings Grant (CESG).

Background The RESP was created as a way for Canadians to save for their children's education without the growth being taxed under the regular attribution rules. Normally, when you give your child money and he or she invests it and it earns interest or dividends, this investment income is taxed as if you had received the income. It is "attributed" back to you. These attribution rules were intended to curb potential abuse by parents trying to slough off income to their children who are taxed at a lower marginal tax rate. However, if you give your child money via an RESP, these attribution rules do not apply.

Previously the rules governing the RESP were onerous. If your child did not attend a qualifying institution (ie college or university), all of the growth: interest, dividends and capital gains went to the educational institution that you designated on your RESP contract.

A lot of money went to these institutions because children did not go to university. In the province of Quebec, almost half the population doesn't complete high school let alone go to university.

The abuse started with the scholarship fund companies that made a business out of selling RESP's. Their salespeople would scour birth notices in the newspaper and call the parents of the newly arrived bundle of joy to set up an appointment to discuss this wonderful program.

Typically one of the parents would fall prey to the salesmans convincing arguments - "You want what's best for your child don't you? You want your child to go to university don't you?" Then the next few minutes would be spent completing applications to purchase an RESP made up of short-term money market instruments and government bonds with a hefty management fee and sales commissions. Often these amounted to more than the parent would have paid in tax under the attribution rules.

So bright financial planners, seeing what was happening, suggested to these parents "Why don't you set up an 'In Trust' account and instead of purchasing short term money market funds and bonds which pay interest and attract tax - buy growth funds and don't sell them until the child goes to university and you need the money?"

At first the client couldn't beleive that you wouldn't pay tax on the growth. The planner would explain that under the income tax attribution rules, while interest and dividends are attributed back to the parent - capital gains are taxed in the hands of the child (or grandchild, nephew, neice, etc.). Then the planner would explain the "Generally Accepted Accounting Principle" the "Realization Principle" which essentially states that you don't count your chickens 'till they're hatched. Just as Revenue Canada will not allow you to deduct un-realized losses, you don't have to pay tax on un-realized gains.

One of the biggest advantages to this strategy was that should the child not attend university you keep the money in the family and the educational institution doesn't get a dime.

The government, seeing what was going on - all of this money collecting in trust accounts, decided to change the rules to

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Rule of Acquisition # 17

A bargain usually isn't.

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make RESPs' more attractive.

Firstly they changed the rules about having to give the growth in the plan to the educational institute should the child not attend university. What they said was "You can have your money back and all of the growth. You don't have to pay the university but we want 20% of your growth as a special tax, and by the way, the remainder is taxed at your marginal tax rate." To make matters worse, dividend income and capital gains are treated as ordinary income in an RESP.

This wasn't enough to get people to stop putting money into "In Trust" accounts so in the last budget the federal government threw in the Canadian Educational Savings Grant (CESG) and said we'll give you a break. Whatever is left over after educational assistance payments have been made, or if your child doesn't attend a qualifying institution, you can transfer the income from the plan to your RRSP up to a limit of $40,000 or your RRSP contribution room limit, whichever is smaller.

Wow! The government is going to give us money! What a bargain! Have you noticed lately that just about every financial institution is telling you how much it's going to cost your kids to go to school in the year 2010 and what a great vehicle the RESP coupled with the CESG is to help you pay for this? Pay close attention to Quarks' rule of acquisition #17 - "A bargain usually isn't".

I am going to show you that this is the case with RESPs' then you are going to thank me and your children are going to thank me.

10% Growth, $2,000 / year RESP Contribution plus Canada Education Savings Grant

Age	Year End Value
0	$2,640
1	$5,544
2	$8,738
3	$12,252
4	$16,117
5	$20,369
6	$25,046
7	$30,191
8	$35,850
9	$42,075
10	$48,922
11	$56,455
12	$64,740
13	$73,854
14	$83,879
15	$94,907
16	$107,038
17	$120,382

10% Growth, $2,000 / year In Trust Contribution No CESG

Age	Year End Value
0	$2,200
1	$4,620
2	$7,282
3	$10,210
4	$13,431
5	$16,974
6	$20,872
7	$25,159
8	$29,875
9	$35,062
10	$40,769
11	$47,045
12	$53,950
13	$61,545
14	$69,899
15	$79,089
16	$89,198
17	$100,318

Let's look at the two tables on this page. The one on the left shows what you would have in an RESP if you made the minimum contribution required to get the maximum CESG of $7,200. That amount is $2,000 per year for 18 years (starting before the child's first birthday), or $36,000.

The second column shows what you would have in an "In Trust" account with the same $36,000 investment. Both examples assume a 10% growth rate.

It's obvious to everybody that $120,382 is better than $100,318 correct? I disagree. I honestly believe that nobody has crunched the numbers. I don't think that there is a single financial advisor in Canada who has

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(Continued from page 7)
taken the time and effort to see what happens to RESP money as it is disbursed. If they did, then nobody would be selling these things.

Let's assume that a four year university progam sometime in the future will cost $60,000. That's $15,000 per year for four years for tuition, books, travel, labs, food, lodging etc.

At the end of the childs education we have this $99,675 to deal with. We are allowed to remove our contributions tax free. The contributions were $36,000. That leaves $63,675 that must be brought into income. The best possible scenario is that you have $40,000 RRSP contribution room in which case the amount that has to be brought into income is $23,675.

If you are in the 50% marginal tax bracket, when you include the 20% penalty, the government gets $16,572 and you get to keep $7,103. If you had contributed the maximum amount to your RRSP each year the amount that you give to the government is $44,572 and the amount you keep is $19,103.

If your child doesn't go to university you have this problem on $120,382 plus you have to pay back the $7,200 CESG.

With the "In Trust" option I am left with $70,299 if the child goes to school and $100,318 if he or she doesn't. If the child goes to school and at the end of university you decided to cash out of this, the child (not you) has to pay tax on the capital gain. A rough calculation is as follows. The capital gain is $70,299 - $25,307 (approx adjusted cost base) or $44,992. Only three quarters of this is taxable or $33,744. Using Ontario 1997 tax tables with only the basic personal credit tax owing on this is $7,569. **The remainder of $62,730 stays in the family!**

RESP Option

Opening RESP balance age 18	**$120,382**
RESP Withdrawal	-$15,000
Balance	$105,382
Opening Balance age 19 including growth	**$115,920**
RESP Withdrawal	-$15,000
Balance	$100,920
Opening Balance age 20 including growth	**$111,012**
RESP Withdrawal	-$15,000
Balance	$96,012
Opening Balance age 21 including growth	**$105,613**
RESP Withdrawal	-$15,000
Balance	$90,613
Balance including growth that must be brought into income.	**$99,675**

In Trust Option

Opening RESP balance age 18	**$100,318**
Withdrawal	-$15,000
Balance	$85,318
Opening Balance age 19 including growth	**$93,850**
Withdrawal	-$15,000
Balance	$78,850
Opening Balance age 20 including growth	**$86,735**
Withdrawal	-$15,000
Balance	$71,735
Opening Balance age 21 including growth	**$78,908**
Withdrawal	-$15,000
Balance	$63,908
Balance including growth	**$70,299**

If the child didn't go to university and decided to cash in his $100,318 the capital gain is calculated as follows: $101,318 - $36,000 = $65318 x .75 = $48988. The tax on this is $13,946 in Ontario using the 1997 tables and only the basic personal credit. This is what the government gets and t**he**

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family keeps $87,372!

Next question - is $15,000 from an RESP better or worse than withdrawing $15,000 from our growth funds?

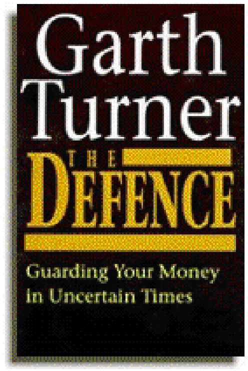
If the child lives in Ontario and pays $1,500 in tuition and attends school for eight months his or her tax payable would have been $1,500 in 1997.

For the child who withdrew funds. The capital gain is calculated as follows: $15,000 - $5,400 (cost) = $9,600 gain of which 3/4 is taxable or $7,200. Guess what, the child pays no tax and can transfer unused credits to his or her parents.

$1,500 in additional tax is almost the equivalent of four years CESG. Unfortunately this is repeated for four years.

In most provinces there is also a student loan and bursary program. In Quebec, a single person not living at home with a $15,000 RESP income would receive $0 bursary (free money). The same person with a $7,200 income (In Trust option) would receive a $1,200 bursary. As with the income tax payable, this goes on for four years. Lastly, not all parents are comfortable with the idea of their children coming into a large sum of money at 18. They are concerned that the kids will go out and buy a Harley-Davidson or join some weird cult. My clients who feel that way keep the growth funds in their name but ear-marked for their childrens education.

Conclusion: Stay away from these plans, they do nothing for you and could cost you thousands of dollars in needless taxes and lost bursaries. Not everyone will agree with me, but I've cruched the numbers starting at different ages and for various contribution levels. If you get a different result **after you've crunched the numbers** I'd like to hear from you.



Review

Some people have remarked that this book should have come out a few months earlier, in time to avoid the recent financial crisis. I couldn't help noticing that many of the valuable insights and practical tips were previously addressed in Garth's newsletter "The Turner Report". You may want to consider subscribing to this newsletter so as to avoid this problem in the future.

Almost half the book, 126 pages are dedicated to "The Great Threats, and How to Survive Them". Each major threat is identified with examples, charts, illustrations and a summary at the end of each chapter. Some of these threats are:

- Market Meltdown,
- Political Instability,
- Retirement Crisis,
- Tax Creep,
- Outliving Your Money

The second part is entitled "Where to Keep Your Money Safe". Fixed Income, Stocks and Mutual Funds are examined.

The third section is "How to Help Yourself". The bulk of this section is dedicated to "Why Everybody Needs an Advisor" and "The Best Defence: Knowledge". Some worksheets are also included.

I've said this before, and I'm saying it again. Read his books, subscribe to his newsletter and attend his lectures.

This book is a "must read". To purchase it directly from Garth go here: http://www.garth.ca

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EDUCATION
Masters Degree in Business Administration, St. Mary's University, Halifax, Nova Scotia, 1982. **Bachelor of Arts (Honors)** in French from St. Thomas University, Fredericton, New Brunswick where he won two academic awards: 1) The Dr. Marguerite Michaud prize for studies in French Canadian literature and 2) The Romance Department prize for studies in linguistics. The third year of this program was transferred from l'Université Laval.

BACKGROUND AND EXPERIENCE

Doug has spent the last five years in the financial services sector. Prior to that Doug worked for the federal government as a budget administrator and internal auditor. This followed several years as a comptroller for a medium-sized firm and several years with KPMG as an accountant.

Useful Links

Fund Performance:
http://www.globefund.com
http://www.fundlibrary.com/home.cfm
Financial Advisor Pages
http://www.fapages.com/links.cfm
Garth Turner's Website
http://www.garth.ca/Default.html

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Don't buy anything based upon what you read here! That's not how you buy mutual funds, invest or conduct your financial planning. You buy investment funds after having sat down with a qualified, licensed professional and after having determined that the fund in question meets your requirements and that it fits into your overall plan. Always take the time to read the fund's prospectus. Fund companies spend a lot of time and money paying accountants and lawyers to prepare these things - read them. Ask your financial advisor about what you read in the prospectus. Go over the financial statements, and the comparative performance figures found therein.